

TO: Files

CC: San Diego Audit Committee

FROM: Willkie Farr & Gallagher LLP

RE: Interview of Sudhir Pardiwala on June 6, 2006

DATED: June 12, 2006

On June 6, 2006, Michael Schachter and Michael Shapiro, in Willkie Farr & Gallagher LLP's capacity as counsel to the Audit Committee, interviewed Sudhir Pardiwala, by telephone from Willkie Farr & Gallagher LLP's offices at 787 Seventh Avenue in New York. Johnny Giang and Thomas Wang from KPMG also participated in the interview by telephone from San Diego. Mr. Pardiwala was not represented by counsel.

The following memorandum reflects my thoughts, impressions, and opinions regarding our meeting with Sudhir Pardiwala, and constitutes protected attorney work product. It is not, nor is it intended to be, a substantially verbatim record of the interview.

Warnings

Mr. Schachter informed Mr. Pardiwala that we are counsel to the Audit Committee and do not represent him or any employee. He advised Mr. Pardiwala that the interview may be considered attorney work product and confidential, but the decision of whether to keep it confidential will be made by the Audit Committee in the best interests of the City, not by Mr. Pardiwala personally. He said that it is important for Mr. Pardiwala to keep the contents of the interview confidential to maintain the integrity of the process. Mr. Schachter said we will create a report which may contain statements of interviewees, and this report will likely be provided to KPMG and ultimately made public. He said government agencies may view the report and may be provided with additional information so it is important to be truthful and accurate. Mr. Pardiwala asked Mr. Schachter who hired us. Mr. Schachter informed Mr. Pardiwala that the City of San Diego hired the Audit Committee which in turn hired Willkie Farr & Gallagher LLP. Mr. Pardiwala asked Mr. Schachter why we are interviewing him. Mr. Schachter informed Mr. Pardiwala that we are conducting interviews of people with relevant information about the City's lack of compliance with sewer rates and because we believe Mr. Pardiwala has relevant information, we have requested this interview.

Background

Mr. Schachter asked Mr. Pardiwala to discuss his professional background. Mr. Pardiwala said that he received a B.S. in Chemical Engineering, an MBA, and a Masters in Engineering. He stated he has worked in the business of developing water and wastewater rates for over 20 years, working for Montgomery Watson for 13 years, then Black & Veatch for 5 years, and for Raftelis Financial Consultants for the past 2 years. Mr. Pardiwala said he has

conducted numerous Cost of Service Studies ("COS") in California, including in many large cities such as Sacramento, San Francisco, and San Jose, as well as in smaller cities.

Cost of Service Study

Mr. Schachter asked Mr. Pardiwala to describe a COS. Mr. Pardiwala replied that a COS identifies how to allocate cost most equitably to customers. He said that a COS determines how to recover costs in a fair and equitable manner.

Mr. Pardiwala was shown Exhibit 1, a February 7, 2000 email from Prabha Kumar to Sudhir Pardiwala, cc'ing Hang Tran re: "City of San Diego RFP for Cost of Service/Rate Design: Add'l Q&A." Mr. Schachter asked Mr. Pardiwala to identify Prabha Kumar. Mr. Pardiwala replied that she worked with Mr. Pardiwala, did rate modeling and still worked for Black & Veatch. Mr. Schachter asked Mr. Pardiwala who designed the questions and answers listed in the email. He responded that the questions were provided by consultants interested in seeking a contract to conduct the COS and the answers were supplied by the City.

Mr. Pardiwala was shown Exhibit 2, a July 24, 2000 email from Sudhir Pardiwala to Patricia Tennyson (Katz & Associates), Dennis Kahlie (Utilities Finance Administrator) and Laurie Schaffer re: "A couple of items." Mr. Schachter asked Mr. Pardiwala to explain the purpose of the email. Mr. Pardiwala replied that Katz and Associates wanted a description of the COS's purpose for the Stakeholders' Group. Mr. Schachter asked Mr. Pardiwala what were the "regulatory requirements" to which Mr. Pardiwala is referring in the email. Mr. Pardiwala replied that the requirements are the Environmental Protection Agency ("EPA") regulations of the Clean Water Program ("CWP"), which he noted are administered by the State Water Resources Control Board ("SWRCB") through Revenue Program Guidelines, which are part of the requirements applicants need to meet to receive federal funding.

Mr. Schachter asked Mr. Pardiwala if he recalled a 1998 COS. He said he "vaguely" recalled a 1998 Pinnacle COS that was not implemented. He said he thought it was not implemented because the Council did not want to implement it. Mr. Schachter asked whether it was not implemented because Kelco did not want it implemented. Mr. Pardiwala said he did not "specifically recall Kelco being the reason."

Mr. Pardiwala was shown Exhibit 3, a November 30, 2001 Sewer Cost of Service and Rate Design Study. Mr. Schachter asked Mr. Pardiwala to describe a draft report. Mr. Pardiwala replied that a draft report allows the City to edit it, check the numbers involved, comment on it, and understand it before the COS goes to the City Council. He said that his work on this particular COS had "pretty much concluded" by November 30, 2001.

Mr. Pardiwala was shown Exhibit 4, a January 15, 2002 letter from Sudhir Pardiwala and Prabha Kumar to Dennis Kahlie re: "Sewer Cost of Service and Rate Design Report," attaching a COS. Mr. Schachter asked Mr. Pardiwala if this was a final COS. Mr. Pardiwala first replied that it was final and then said that it was a second draft. He said that this COS relied on 1999 data. Mr. Schachter asked Mr. Pardiwala if this COS could have been implemented by the City. He replied in the affirmative and noted that had the City done so, it would have been in compliance.

Mr. Pardiwala was shown Exhibit 5 a February 1, 2002 email from Dennis Kahlie to Mary Vattimo (City Treasurer) and Patricia Frazier (Deputy City Manager) re: "Revenue Plan Issues." Mr. Schachter asked Mr. Pardiwala if this email is consistent with his recollection that he was finalizing the COS during January and February of 2002. He replied that it is consistent with his recollection and assumed the second draft or the final draft would go to the Council in that time frame.

Mr. Pardiwala was shown Exhibit 6, a February 1, 2002 email from Dennis Kahlie to Ed Ryan (City Auditor and Comptroller), Mary Vattimo, George Loveland (Deputy City Manager), Patricia Frazier, Richard Mendes (Deputy City Manager), Bob Ferrier, Scott Tulloch (Director of the Metropolitan Wastewater Department ("MWWD")), and Bill Hanley (Deputy Director for Contract Services, MWWD) re: "Draft Cost of Service Study for Internal Management Review." Mr. Schachter asked if this COS was in final form. Mr. Pardiwala said that it was in "substantially final form" and only some minor editing needed to be done. Mr. Schachter asked Mr. Pardiwala when the COS was circulated to Council. He did not know.

Mr. Schachter asked Mr. Pardiwala if he had a final copy of the COS. Mr. Pardiwala replied that Black and Veatch submitted a final COS in April 2002 and noted that it was after April 23, 2002.

Mr. Pardiwala was shown Exhibit 7, a November 22, 2002 memorandum from P. Lamont Ewell (Deputy City Manager) to the Honorable Mayor and City Council attaching a May 2002 COS hand-stamped "draft." Mr. Schachter asked Mr. Pardiwala if the May 2002 COS was a draft. Mr. Pardiwala said that the May 2002 COS was stamped "draft" but not by Black & Veatch. He suspected it was the final COS. He noted the final COS was usually issued with a letter but did not know why there was no letter attached to this COS. He assumed the May 2002 COS was final but could not say for certain. He said from Black & Veatch's perspective, this May 2002 COS was probably a final report. He said he remembered that by the time this May 2002 COS was done, the rates included were no longer applicable. He said he could therefore understand why it was stamped "draft" and referred to as a "draft." He said it had been three years since starting this COS and the rates were "outdated by November 2002 for sure." However, he noted that the City could still have implemented the May 2002 COS.

Mr. Pardiwala was shown Exhibit 8, an October 1, 2002 email from Dennis Kahlie to Patricia Tennyson and Eric Adachi (Rate Analyst, Supervising Economist, MWWD) re: "A question from someone from the past..." Mr. Schachter asked Mr. Pardiwala to explain the delay between the draft study being completed in January 2002 and this email in October 2002. Mr. Pardiwala replied that he submitted the COS and could not recall the "hangup." He said he thought either the City Manager or the Council stopped the COS but did not know which one did so. Mr. Schachter asked Mr. Pardiwala if he had any other information to explain the delay. He said he did not hear of Council reaction to the COS. He said he recalled hearing that too much time had passed so the COS had to be updated. Mr. Schachter asked Mr. Pardiwala if he recalled conversations with Patricia Tennyson about the need to recalculate the COS. He said he did not recall such conversations but was sure they discussed the issue.

Recalculating a COS

Mr. Schachter asked Mr. Pardiwala how long it took to recalculate a COS. Mr. Pardiwala said that it took 2-3 months to obtain the new data and then 3-4 months to complete the COS. He said that getting data was the biggest problem and took a lot of time. He said that San Diego had a complicated wastewater system which required lots of data from different areas to do the COS.

Toning Down the COS

Mr. Schachter asked Mr. Pardiwala if he recalled any discussion about toning down the COS once it was completed. He said that he did not but then said that Mr. Kahlie told him it was Mr. Kahlie's preference and the City's to have the COS language include words like "proposes" and "suggests" rather than "should." Later in the interview, Mr. Pardiwala noted that he could not find toned-down language in the COS.

Cost of COS

Mr. Schachter asked Mr. Pardiwala how much he charged for the COS. He said the first contract was \$250,000 and then there was an amendment because the COS was more costly than expected because of the need for updated data. He said the 2003 COS incurred additional costs and had to be updated in its entirety.

State Awareness of Noncompliance

Mr. Pardiwala was shown Exhibit 9, a September 12, 2000 facsimile from Eric Adachi to Sudhir Pardiwala and Prabha Kumar, attaching correspondence with the State. Mr. Schachter asked Mr. Pardiwala if it was the State's intent to include San Diego when it required the City to incorporate chemical oxygen demand ("COD"; Organics) for the Participating Agencies ("PAs"). Mr. Pardiwala replied that San Diego was one of the PAs so the State was including the City in its demand to incorporate COD. He said that Ron Blair (Revenue Program Specialist for the State Water Resources Control Board) knew that the City was not billing on the basis of organics for its own users. Mr. Schachter asked when Blair knew. Mr. Pardiwala replied that he thought Blair knew as early as 1994.

Mr. Pardiwala was shown Exhibit 10, a June 27, 2001 email from Sudhir Pardiwala to Dennis Kahlie, Eric Adachi, and Prabha Kumar re: "redrafted letter," attaching a draft redline letter from Ron Blair re: "Wastewater Revenue Program Cost Allocation Methodology." Mr. Schachter asked Mr. Pardiwala what Blair was referencing in the letter when he wrote "The City's current user charge system." Mr. Pardiwala said that the phrase referred to the methodology Black & Veatch was proposing at the time and did not necessarily mean that Blair thought the City was allocating based on COD at the time. Mr. Schachter asked Mr. Pardiwala if he had any conversations with Blair about the City not allocating COD at that time. Mr. Pardiwala said "absolutely." He said he spoke with Blair to get an opinion on the elements regarding marginal biological oxygen demand ("BOD"; organics) versus average BOD. He said Blair knew the City had to include BOD for City users. Mr. Schachter asked Mr. Pardiwala if he discussed with Blair that the City user charge system was not compliant with State requirements. Mr. Pardiwala said that "with almost 100% guarantee" he spoke with Blair

and Blair knew that the City did not include COD in its own rate structure. He noted that Blair conducted biannual surveys that would have told him so. Mr. Schachter asked Mr. Pardiwala if he recalled conversations with Blair in which the City's noncompliance was discussed. Mr. Pardiwala said that with "almost 100% certainty" he talked with Blair about it. He said he spoke with Blair about how Blair thought the cost allocation regarding organics should be done by the City. Mr. Pardiwala noted that there was some flexibility regarding the allocation of costs but there must be the inclusion of organics if the City was treating for organics. He added he was "positive that Blair knew the City was not in compliance." He recalled that Blair discussed with the City that Blair would have to call the City's grants and loans if the City did not comply with the organics requirement. Mr. Schachter asked Mr. Pardiwala if Blair would be wrong if Blair said he did not know that the City was not charging for COD. Mr. Pardiwala said that Blair would be wrong. Mr. Schachter asked Mr. Pardiwala if he was troubled about the City's lack of compliance with State requirements. Mr. Pardiwala replied that the State was flexible about approving programs without forcing the City to include COD so he was not concerned.

Mr. Pardiwala was shown Exhibit 11, an October 2, 2000 email from Patricia Tennyson to Sudhir Pardiwala, Dennis Kahlie, Eric Adachi, Hedy Griffiths (Supervising Management Analyst, Agency Contracts, MWW), and Bill Hanley re: "Comments Re Karen Keese's E-mail." Mr. Schachter asked Mr. Pardiwala to explain his comments in the email. Mr. Pardiwala said that there were various allocation methods. He noted that industry practice was to allocate on the design basis which meant based on the primary design factor. He said that strictly from that perspective, primary treatment was not designed for BOD removal. However, he noted that the City's primary treatment was designed to remove BOD because it was advanced primary treatment. He added that for typical primary treatment, BOD/COD allocation was not needed but it was needed for San Diego because San Diego did advanced primary treatment. Mr. Schachter asked Mr. Pardiwala to explain his comment in the email, "In my mind charging to COD as the City currently does is acceptable though not necessarily required." Mr. Pardiwala replied that it was not a "fair statement" for the City's system but was fair for the typical primary system. Mr. Schachter asked Mr. Pardiwala if the email in its entirety corroborated whether Mr. Pardiwala spoke with Mr. Blair about the City's lack of compliance with the organics requirement. Mr. Pardiwala said that the email showed that he had discussion with Mr. Blair about the BOD allocation and corroborated that Blair knew. He said that the email could be susceptible to an interpretation that Blair was just thinking that the City was reallocating regarding BOD and not allocating BOD for the first time.

Mr. Pardiwala was shown Exhibit 12, an October 31, 2000 email from Prabha Kumar to Dennis Kahlie and Sudhir Pardiwala re: "Working on the David M issue." Mr. Schachter asked Mr. Pardiwala to explain a comment in the email, "The regulators required that COD be included in the City's rate structure." Mr. Pardiwala said that the comment indicated that the City was required to include COD because of regulatory requirements. He said that it demonstrated that Blair was aware that the City did not include COD in its rate structure.

Mr. Pardiwala was shown Exhibit 13, a May 22, 2001 letter from Dennis Kahlie to Ron Blair re: "Wastewater Revenue Program Cost Allocation Methodology." Mr. Schachter asked Mr. Pardiwala if the first sentence of the letter beginning, "As you're aware..." demonstrated that Blair was aware that the City was not billing based on organics. He said that the letter made clear that the PAs were being treated differently from the City.

Mr. Pardiwala was shown Exhibit 14, a November 8, 2002 email from Dennis Kahlie to Patricia Frazier re: "Cost of Service Bullet Points," attaching a document entitled "Salient Points Sewer Cost of Service Compliance Issue November 11, 2002." Mr. Schachter asked if the fifth bullet point on page 2 of the Salient Points was true. Mr. Pardiwala said that it was "probably true." He said that Blair may have assumed that when COD was allocated for the PAs, it applied to the City too. He said that when Black & Veatch came on board in 1999, he was "pretty sure" that Blair knew that the City was not in compliance. He said Blair might have thought the City was in compliance up until 1999. Mr. Schachter asked Mr. Pardiwala when Blair definitely knew the City was not in compliance. Mr. Pardiwala said by 2000.

Incorporating Chemical Oxygen Demand

Mr. Schachter asked Mr. Pardiwala if EPA regulations require that rates must be proportional to the cost of treating wastewater from particular users. Mr. Pardiwala replied in the affirmative and noted that the EPA regulations did not say that COD must be included. Mr. Pardiwala also noted that the SWRCB mandated charging based on proportional use but did not necessarily mandate charging based on COD. Mr. Schachter asked Mr. Pardiwala if the City requested Black & Veatch introduce the allocation of COD to the City's rate structure. Mr. Pardiwala replied that the original request for the City to allocate for COD came from Blair in a letter regarding the need to comply with regulations and introduce COD. Mr. Schachter asked Mr. Pardiwala if he understood that the State required rates to include COD. Mr. Pardiwala replied in the affirmative and noted that typically, COD needed to be included as a parameter, specifically if recycled water treatment plants were in use. Mr. Schachter asked if it was Mr. Pardiwala's understanding that for municipalities at secondary treatment, COD was a condition of the municipality's grants and loans or whether it was a requirement of the Clean Water Act ("CWA") or both. Mr. Pardiwala replied that the requirement to include COD was a requirement of the CWA. He noted that the City could set rates without following EPA regulations regarding the rate structure but still had to meet EPA permit requirements, even if the City had no grants or loans. He added that the EPA would not enforce its regulations if the City did not receive federal funding. Mr. Schachter asked Mr. Pardiwala if a municipality was at secondary treatment, could proportional rates be set without including organics. Mr. Pardiwala said that the municipality "should consider organics" and that including organics was the "only way to do it." He added that it was a "requirement to have an organics component for grant-funded facilities."

Mr. Pardiwala was shown Exhibit 15, a February 18, 2000 proposal for Sewer Cost of Service and Rate Design Services from Sudhir Pardiwala, Senior Project Manager, to Dennis H. Kahlie, Utilities Financing Administrator. Mr. Schachter asked Mr. Pardiwala if it was unusual for a municipality to not include COD. Mr. Pardiwala replied in the affirmative, noting that most municipal systems were funded by federal grants and loans. He said that all COS's he did included COD in the municipality's rate structure. He noted that San Diego was the only municipality he worked with that was not at complete secondary treatment.

Mr. Schachter asked Mr. Pardiwala why the City was not compliant with the COD requirement. Mr. Pardiwala said that he recalled speaking with Kahlie and Adachi about it but did not recall their response.

Proposition 218

Mr. Schachter asked Mr. Pardiwala if Proposition 218 required the City to change its rates. Mr. Pardiwala replied that he was not sure Proposition 218 required such a change. He said that it could be argued that Proposition 218 required the City to allocate costs in a fair manner. He said a good case could be made that San Diego could not fulfill Proposition 218 without an organics parameter. He reiterated that he believed that proportional rates must include COD.

Changing the Rate Structure

Mr. Pardiwala was shown Exhibit 16, a May 9, 2000 City of San Diego Metropolitan Wastewater Department Sewer Cost of Service & Rate Design Services Agenda. Mr. Schachter asked Mr. Pardiwala to explain the "Political issues" item noted on the Agenda. Mr. Pardiwala said that the political issues involved "customer dissatisfaction." He said that the City Council was sensitive to the impact of significant changes in the rate structure on customers. He noted that the changes were revenue neutral but would increase costs to industries and decrease costs to residents. He clarified that before the study was commenced, the City did not know how residential rates would be impacted.

Mr. Pardiwala was shown Exhibit 17, a September 6, 2000 email from Sudhir Pardiwala to Prabha Kumar re: "San Diego Meeting." Mr. Schachter asked Mr. Pardiwala to explain the third bullet point, "Discuss the difference between a revenue requirements analysis and a cost of service study..." Mr. Pardiwala said that they were not discussing total revenues that needed to be collected or why they needed to be collected, only how to allocate the total revenue needed to the customer classes in a fair and equitable manner. Mr. Schachter asked Mr. Pardiwala to explain the sixth bullet point, "Review Federal and State Funding of treatment facilities and obligations of the City with respect to compliance with cost allocation and rate structure requirements..." Mr. Pardiwala replied that changing the rate structure was a precedent to receiving grants and loans. He said he may have spoken to Blair about that.

Resistance to Changing Rates

Mr. Pardiwala was shown Exhibit 18, a March 8, 2001 email from Patricia Tennyson to Rashee Rohatgi re: "Final Draft of Stakeholders' Group report." Mr. Schachter asked Mr. Pardiwala if he recalled how Deputy City Manager George Loveland or City Manager Michael Uberuaga reacted to changing the rate structure. He did not recall. He did not hear of resistance on their part to changing the rate structure. Mr. Schachter asked Mr. Pardiwala if he knew who was the "guy the mayor has" noted in the email. He did not.

The State's Threat

Mr. Schachter asked Mr. Pardiwala if the potential threat that the State would recall the grants and accelerate the loans was real. Mr. Pardiwala said that the threat was potentially real. He said the State was capable of exercising its threat and noted that Blair was "stringent" about requirements and "pretty aggressive."

Quantification of Overcharge

Mr. Schachter asked Mr. Pardiwala if he could quantify how much residential users were overcharged. He said he was currently working with the City on an analysis but it was very difficult. He said that various elements changed over the years including different fixed charges for single versus multiple-family residences; the lack of COD in the rate structure; the hcf cap for single family residents was increased from 10 hcf to 14 or 16; and wastewater flow had entered the plants at a higher rate than the hcf cap. He said that for fiscal year 2004 versus all of 2004, single families would have paid \$12.5 million less if COD was properly allocated.

Conclusion

Mr. Schachter requested that Mr. Pardiwala keep the contents of the interview confidential to maintain the integrity of the process. Mr. Schachter requested that if Mr. Pardiwala recalled any information he believed a relevant to our investigation, he should contact us.

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